

## THE ROAR THAT BECAME A WHISPER

Soon after the state of Israel was established in 1948, its economy took off, with vibrant economic growth continuing for twenty-three years (Table 1.1). After 1973, however, this vigorous growth was replaced by sluggishness and a very disappointing rate of economic expansion, barely sufficient to sustain the rate of per-capita production attained in 1973.

The story of how growth was replaced by stagnation is the story of the past two decades of Israel's economy. We will see that the roar became a whisper largely because of the semisocialist arrangements on which the economy was founded, many of which survive to this day.

The term *socialism* is used here in its strict sense: the collective ownership and allocation of an economy's means of production.<sup>2</sup> According to this definition, Sweden, often referred to as *socialist*, is not: it has the highest incidence of private ownership of any Western economy.<sup>3</sup> *Socialism* is used interchangeably to describe the ideology and to identify the organizational setup within which the norms laid down by the ideology are being pursued. This semantic problem does not exist with capitalism, which is the institutional setup spawned by liberalism.

TABLE 1.1  
Growth of Real GDP,\* Annual Averages

Period	Percent	Period	Percent
1950-55	12.6	1971-75	7.1
1956-60	8.8	1976-80	2.6
1961-65	9.8	1981-85	2.8
1966-70	7.7	1986-89	3.1
1950-73	9.7	1974-89	2.8

\*Gross Domestic Product.

Source: Central Bureau of Statistics,<sup>1</sup> *National Accounts*, various years.

These distinctions are important, since the institutional setup is crucial in determining the functional efficiency of an economic system. This can be most sharply demonstrated by noting that in the Soviet version of socialism, the institutional system tried to replace the market institution. This has probably been the most important factor in the spectacular collapse of the communist economic system, and it is also what made Western economists so confident that the communist system could not ultimately deliver on its promises.

In contrast, the Israeli system recognizes the forces of supply and demand. Hence, to a casual observer it looks as though the Israeli economy works like a capitalist one, except that the government is more heavily involved. The task of attributing Israel's economic failure to socialism is thus made more difficult. Israeli socialism is, as one might put it, more subtle.

The use of the adjective *socialist* in the description of the Israeli economy hinges on three central attributes of the institutional system. First, there has been virtually no free access to the capital market. For many years, there was almost no way to raise capital in Israel except through the government. Hence, even though a substantial share of capital is not collectively owned, almost all of it has been collectively allocated. Second, a substantial proportion of the means of production has been owned either by the government or by the Trade Unions Federation—both forms of social ownership of the means of production. This is true of much of the capital, but most particularly of the land, which is 94 percent socially owned. Third, the wage structure reflects the attempt to implement the basic socialist welfare criterion.

This is, then, the sense in which the term *socialism* is being used throughout. As we shall see, some of the more important consequences of this structure resemble the obstacles that the ex-communist world confronts.

### The Bumpy Road of Political Economy

The task of identifying certain traits in an economy as the causes for longstanding problems is a very treacherous one. The difficulty emanates from the fact that it is impossible to *prove* assertions in this field in the usual, scientific sense of the word. Propositions in economics, other than in the context of pure economic theory, are not prone to proofs in general, for the simple reason that virtually no experimentation at all, and certainly no controlled experimentation, is possible. In this respect, economics is in much the same position as meteorology. A meteorologist cannot create in the laboratory mini-weather systems that exactly duplicate natural ones. And because weather patterns are quite varied, no clear rules can be established other than in extreme situations. For example, it can be stated with certainty that wherever a hurricane will pass, it will rain. But the spectrum of weather patterns that involve cloudiness is so wide that definite statements about the relation

between clouds and rain are virtually impossible. Instead, meteorologists rely on statistical analysis of past, observed weather patterns, which allows them to produce probabilistic forecasts, such as "a 70-percent chance of rain."

Like meteorology, economics can also use statistical observations to try to establish relations between various events. But in only very few cases can the results be stated as a rule or theorem, and no amount of statistical analysis can "prove" anything. It merely helps investigators to strengthen their beliefs. Even statistical analysis is limited to those phenomena that are relatively narrow in scope, such as specific supply or demand relations, cost of production, and so forth. In particular, no statistical analysis can be expected to do any good when it comes to assessing or comparing entire economic systems.

To help clarify the point, consider the following assertion that concerns an entire economic system: *the Soviet economy has performed poorly because of its communist form of organization*. If one believes this statement to be true, it is probably not due to the refined results of statistical regression analysis. Rather, it is based on casual observations of living conditions in the Soviet Union and basic notions concerning the incentives that drive individuals to be industrious; that is, those that create the circumstances for the existence of a productive economic system.

The diagnosis of the communist form of economic organization as the cause for the Soviet Union's economic troubles is by no means the only possible one. For example, one might suggest that the Soviet economy faces a variety of difficulties unique to the Soviet Union and that have nothing to do with communism. Such difficulties might be the lack of access to a warm-water port, a harsh climate, a large population with cultural and religious backgrounds that are not particularly conducive to rapid economic growth, a war that devastated large parts of the economy, a dictatorial form of government. Yet even if statistical analyses were to be presented to back up these latter explanations, it is unlikely that anyone who had been initially convinced by the argument that ascribes the Soviet economic failures to communism will have changed his or her mind in light of such analyses.

This demonstrates both the strength and weakness of the way by which we form opinions about economic systems. The strength lies with the fact that we have to refer to a basic conceptual framework and a broad body of knowledge concerning human behavior. The weakness concerns the temptation to select from the observed facts only those that support our preconception. This selectivity is facilitated by the fact that, in the absence of methodical statistical analysis or experimentation, we are not subject to the discipline imposed on us by the procedure of these methodologies.

Given the history of the Israeli economy, the task of establishing a causal relationship between the socialistlike structure of the economy and its poor performance for the past two decades is far from easy. What makes it possible

to pass unequivocal judgment concerning the performance of the Soviet economy, for instance, is its very long history of stagnation. While the free world had its share of crises, it always rebounded. The Soviet economy, on the other hand, slowly grinded to a halt, producing in the end the Gorbachev revolution. Israel, in contrast, does not feature such clear-cut evidence. In broad terms, the length of time during which the economy grew vigorously still exceeds the period of dull performance. If Israel had failed to grow all along, the sort of statement made about the Soviet economy could have been applied to Israel as well. All one would have to do is convince the reader that Israel's economy does indeed feature many attributes that render it incapable of economic growth at rates common in the free world. However, given the brisk pace of growth during the first twenty years following Israel's War of Independence, the task of justifying the diagnosis is greatly complicated. As we shall see, the very features of the Israeli economy that will be blamed here for the poor economic performance since 1973 had been present all along. Yet for two decades the economy managed to perform very nicely despite that presence.

This is not the only difficulty. Another problem emerges in the fact that growth declined abruptly around 1973. This precludes the possibility that the obstacles to growth had been gathering momentum until they finally became strong enough to depress growth rates. For such a story to be credible, one would expect to observe gradually declining growth rates, rather than a sudden death. The reason is simple: mounting obstacles are likely to affect some parts of the economy sooner than other parts, and there are also likely to be differences in the intensity of the obstacles' impact.

The suddenness with which growth rates declined, combined with its timing, has produced an explanation viewing the entire development as a consequence of wrong policy reactions to the twin crises of 1973—the Yom Kippur War and the Oil Crisis.<sup>4</sup> This, it is argued, both stifled growth and created the decade-long inflationary process that brought the country's economy dangerously close to collapse. It also created the vocabulary economists frequently use when talking about recovery. The key phrase here is *resumption of growth*, which suggests what the country must do is return to the pre-1973 path in terms of the structure of priorities and the policies engineered to achieve them. The implication is that nothing had been fundamentally wrong with the pre-1973 economy. If this is true, then it cannot be argued that the economy has contained all along some basic faults whose presence stymies growth.

An argument that places the blame for Israel's failure to grow on a fundamentally flawed structure must therefore establish that things were not all right prior to 1973. It must be demonstrated that the fast growth rates that the economy had experienced for two decades happened despite the flaws and were facilitated by special circumstances.

The essence of the argument offered here is this: during the early stages of development there are opportunities for large-scale investment that are easy to identify. Prime examples are infrastructure, such as roads and electricity, and residential construction. Massive investment in these and other projects generates rapid growth not only in those sectors of the economy at which the main thrust of investment is aimed, but also in related sectors. For example, a rapid growth in residential construction generates growth in the construction-equipment economy, in the cement industry, and in the industries that specialize in housing fixtures, such as glass and plumbing fixtures. Similarly, road construction spawns an expansion in quarrying and road-construction equipment.

Industrial investment, too, comes relatively easily. In the early stages of development, when wages are low, large numbers of workers can be employed in traditional industries, such as textiles, steel, and shipbuilding.

During early development, the ease with which projects can be identified, and the relatively large chunks of capital that each such project can absorb, make it possible for governments to become the major investors. This means that during the early stages, the availability of private entrepreneurs is not that crucial to generate growth. Their ability to spot opportunities and exploit them is not sorely missed because it does not take their special capabilities to identify opportunities. Put differently, the difficulties into which centralized economic planning and management are bound to run eventually are not serious enough during the first stages of development.

But as the economy becomes more complex, and investment opportunities become less obvious, the economy must rely on the private entrepreneur to discover the niches of relative advantage, a discovery process in which a cumbersome bureaucracy has a distinct disadvantage. It is also the stage when an increasing part of investment takes the form of relatively small initial outlays, magnitudes of little interest to bureaucrats. When the required class of entrepreneurs does not exist, or is relatively small, or if private enterprise finds it hard to pick up where the government has left off because of the institutional rigidities it left behind, the economy will stop growing. This is when the major drawbacks of central planning show. As we shall attempt to show, the dominating role played by the government during the first two decades created an environment hostile to private enterprise, so when the government could no longer play the role of the major entrepreneur, there was no one to replace it.

Centrally planned economies do indeed grow fast in the early stages of development. Table 1.2 contains data concerning Israel and three Eastern European countries whose economies were completely centralized during the period covered by the table. The table also contains data for West Germany, which is ideal for comparison with its eastern neighbor, as both started from roughly the same ruinous state after World War II.

TABLE 1.2  
Early Development Growth Rates, Percent per Year

Country	1950-55		1955-60		1960-65	
	GDP*	NCF**	GDP	NCF	GDP	NCF
Israel	13.0	10.2	9.2	6.4	9.9	10.2
West Germany	9.1	12.7	6.0	7.3	5.0	7.1
East Germany	13.0	36.6	8.0	20.9	2.7	3.1
Poland	8.8	13.2	6.7	10.1	6.0	7.9
Yugoslavia	11.2	8.2	9.7	14.0	7.6	6.7

\* Gross Domestic Product; for Eastern European countries, Net Material Product.

\*\* Net Capital Formation

Source: Data except for Israel: United Nations, *Yearbook of National Accounts Statistics*, 1969, vol. II, Tables 4A, 4C. See also Table 3.1 in Alan H. Smith, *The Planned Economies of Eastern Europe* (New York: Holmes and Meier, 1983). The growth rates he quotes for Poland are almost identical to the U.N.'s, and the rates for East Germany are higher, especially for 1960-65, where he reports a growth rate of 5.8 percent. But see also U.S. Bureau of East-West Trade, *Selected U.S.S.R. and Eastern European Economies Data* (June 1973), where the GNP of East Germany is estimated to have grown an average 3.3 percent from 1960 to 1965. The rates for Poland and Yugoslavia are also quite close to the U.N.'s for 1960 to 1965.

The salient feature of the table is the rapid growth experienced by the three communist countries during the early stages of their development. East Germany grew even faster than its western counterpart. The very rapid rate of capital formation is also common to the countries considered, as is the marked tapering off of both capital accumulation and economic growth.

Similarly, early fast growth in Israel was indeed generated to a very substantial extent by the government. Therefore, early economic growth at reasonable rates is not inconsistent with central planning or heavy government involvement.

This does not mean, of course, that a strategy of early development led by the government necessarily yields good results. Such a strategy has failed miserably in virtually all of the newly enfranchised African states.

#### Early Growth in Israel

Figures 1.1 and 1.2 contain the facts asserting that growth during the first twenty years occurred because it was easy to grow, more or less regardless of the institutional setup of the economy. Figure 1.1 summarizes the characteristics of investment in residential construction, whereas Figure 1.2 does

the same for all nonresidential investment in fixed assets.<sup>5</sup> Both figures depict variations in the rates of change of investment. That is, rather than plotting the absolute rate of investment against time, they plot the rate of change of investment against time. The reason is this. Let us assume that economic growth depends on the net stock of capital at the disposal of the economy. The net stock is the outcome of gross investment over the years, less depreciation of the existing stock, which we shall suppose to proceed at a fixed rate (e.g., 10 percent of the capital stock available at the beginning of a year depreciates during the year). Then it can be shown that if the net capital stock is to grow at a sustained given rate, then investment must grow at the same rate. The significance of this becomes obvious when we think of the net capital stock per person or per employed person. If we wish to at least keep the standard of living from sliding, then the net stock of capital per capita must remain constant, which means that it must grow as fast as the population, which implies that investment must grow at the same rate. Indeed, per-capita growth of Israel's economy has been negligible between 1973 and 1989. It is important to note that points in Figures 1.1 and 1.2 that lie below the horizontal axis represent absolute declines in the rate of investment.

Let us concentrate first on the period up to 1967, starting with residential construction. Immediately after Israel gained independence, immigrants came

FIGURE 1.1

Investment in Residential Construction: Percentage Change and Shares

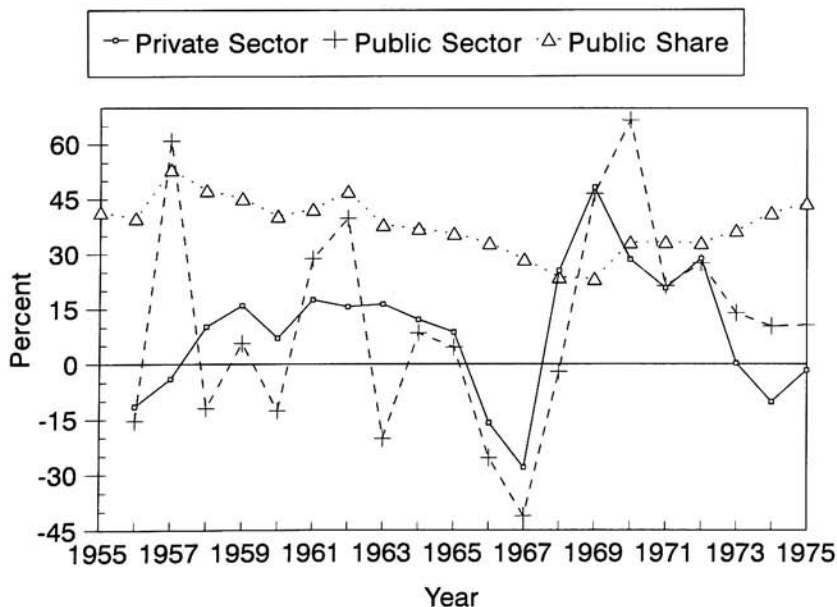
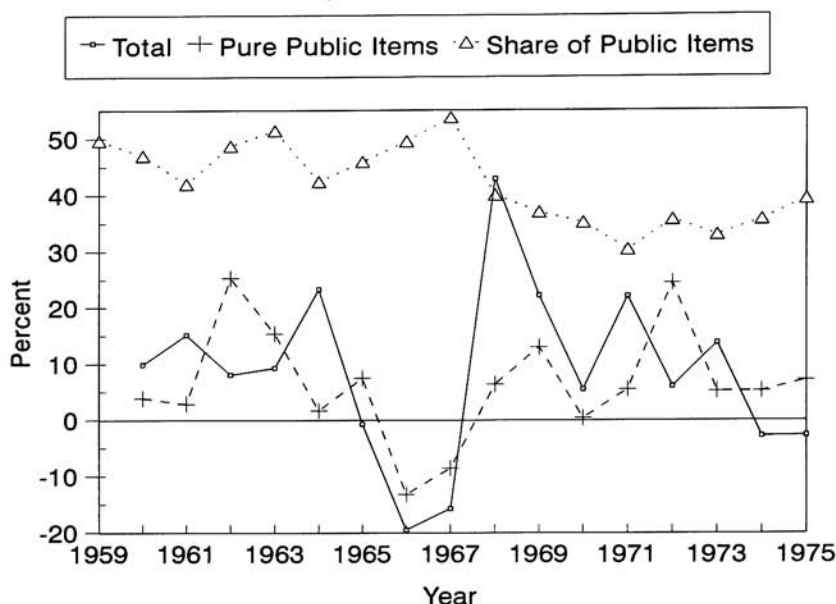




FIGURE 1.2

Investment in Fixed Capital: Percentage Change and Shares



flooding into the country. But by 1952 the tide had subsided, and another surge came only in 1955–57, albeit a much smaller one than the first. The rapid expansion of the population required considerable investment in housing, and throughout the period 1955–66, such investment hovered around one-third of all investment in fixed assets. Because gross domestic investment grew over those years at an average annual rate of over 8 percent, residential construction maintained its place as a generator of growth. It did not require sophisticated capital equipment, and labor was abundantly available as a result of all that immigration. Construction spawned, in turn, investment in construction equipment and high rates of growth in the cement industry, quarrying, and transportation. For example, from 1960 to 1966 the gross capital stock in the construction industry grew by an average annual rate of 13.5 percent.<sup>6</sup>

The 1955–57 surge in immigration is clearly manifested in Figure 1.1 by a large increase in the rate of change of investment in construction by both the public and the private sector. The figure also reveals that, except for a blip in 1961 and 1962, the share of public investment in residential construction declined continuously from about 53 percent in 1957, to less than 24 percent in 1968, a cut of more than one-half in the government's share in only ten years. The blip coincides with another surge in immigration, which lasted from 1961 to 1965, with the peak years being 1962 and 1963. By 1965 immi-



gration declined to less than half the 1964 level. As is evident, the private sector reacted in an entirely reasonable way. From 1961 to 1965 the curve representing the private sector is very smooth, but the curve representing the public sector indicates violent fluctuations.<sup>7</sup>

The steady decline in the government's share in residential construction occurred because the reason for its intensive activity no longer existed. In fact, by 1964 an excess supply of apartments was beginning to accumulate, after a hefty increase in construction. Ironically, part of that increase was attributed to rumors concerning a pending government decree intended to limit new housing starts.<sup>8</sup> Naturally, the prolonged construction boom brought about a considerable upgrading of the standard of housing: whereas in 1957 some 25 percent of the population resided at a density of three or more to a room, by 1967 only 10 percent lived that way.<sup>9</sup>

Figure 1.1 also suggests that 1962 constituted a turning point in the growth of investment in housing. The general trend of both the rates of change of total investment and government investment in housing turned downward. Indeed, although over the period 1956–62 investment in housing grew annually at an average of 8.4 percent, over the period 1963–67 it declined by about the same percentage. Although government investment grew at an average of 10.4 percent over the first period, it declined at an average annual rate of almost 17 percent over the second. The more rapid decline in government investment in housing explains, of course, the decline in its share of the activity. The importance of this half-decade-long decline will soon become evident.

By 1965 it had become clear that immigration rates were rapidly declining: net immigration dropped from about 48,000 in 1964 to roughly 23,000 in 1965, and then plummeted to a little over 8,000 in 1966. Although the rate of investment in housing still increased in 1965, a surplus of housing was already evident. The reaction in 1966 was very sharp: total investment in housing plunged by almost 20 percent and the government reduced its investment by over a quarter as compared to 1965.

Turning to investment in nonhousing fixed assets, one encounters an even greater extent of government involvement than in housing. Over the period 1959–67, the public sector (including nonprofit organizations—mainly universities and hospitals) either carried out or initiated, on the average, 54 percent of total investment in plant and equipment. That vastly underestimates the government's role, because much of the means that flowed from savers to investors directly were directed by the government. This aspect of how the government dominated the allocation of investment resources will become clear in Chapters 2 and 3.

Figure 1.2 describes the rate of change of investment in fixed assets other than housing and the rate of change of investment in those sectors in which the government was virtually the sole investor. These include agricul-

ture, water transportation and irrigation systems, mining, electricity, construction for public services, construction for government-run communications such as the postal service, and construction of roads and ports. The third line in the figure depicts the share of these pure government items in total investment in fixed assets other than housing.

Some of the items listed as pure government ones typically belong to the infrastructure category, where governments all over the world are heavily involved. Of the items that cannot be classified as infrastructure, agriculture and mining stand out. The preponderance of the government in the financing of the agricultural sector stems from ideological and political reasons, which will be given wide attention in the proper context. Suffice it to say here that the government has undertaken to settle Israel's lands, more or less regardless of profitability.

All natural resources in Israel are either nationally owned, as in the case of phosphate deposits and part of the water resources, or subject to government control by law, as in the case of privately owned water wells; again, this is ideological.

As in Figure 1.1, we note first that the share of the pure government items displays a declining trend, which this time stretches all the way to 1971. Still, we shall concentrate first on developments up to 1967, as we did with regard to housing. It is also evident that, just as in the case of housing, the rates of change of investment in the pure government items declined after 1962, and in 1966 and 1967 even the absolute rate of investment declined.

The reason for the decline is that several large projects, of the sort that are easily identified and can swallow large chunks of capital, came to an end. The first part of the curve, from 1959 to 1962, which shows an upward trend, coincides with the start or continuation of these projects.

Included are the Haifa 2 and Ashdod 2 power plants together with power transformation stations, the copper and phosphate mines and especially the Dead Sea Works and the Eilat-Be'er Sheva oil pipeline. The Ashdod port was constructed, the port of Haifa expanded, and a lot of investment in the construction of schools and hospitals took place. One of the more ambitious projects was the construction of the National Water Carrier. This is a system of pipes, canals, tunnels, and reservoirs that transports water from the Sea of Galilee to the arid southern parts of the country. In contrast, the farm sector began to produce surpluses in certain areas, and so investment in agriculture was on the decline.

The three years 1959-61 also saw considerable activity in the construction in Jerusalem of the new campus of the Hebrew University, the Hadassah Hospital, and the Ben-Gurion government offices complex. The World Bank financed a road construction project. There was also considerable investment in the postal service and the telephone system.

In 1964 the National Water Carrier was completed, and investment in water systems dropped sharply. The farm sector generated surpluses in an increasing number of products, which meant curbs on further expansion of production and hence slower investment. Procurement of equipment for the telephone system constituted 80 percent of all purchases of equipment for the transportation and communication sector (excluding vehicles). There was also a large increase of investment in industrial structures commissioned by the public sector. In its 1964 report, the Bank of Israel (the Bank, Israel's central bank) noted the bulky nature of much of the government's investment activity, but it did not draw any conclusions from this observation. As more and more projects were completed, investment continued to drop in 1965 and 1966.

The story of this first period would be incomplete without reference to the growth of industry. Over the five years from 1960 to 1965, investment in industry grew at an average annual rate of 6.6 percent. Much of it was government financed, either directly or through intermediaries getting their instructions from the government. However, this does not constitute a sufficient explanation for industrial growth. What does provide at least a partial explanation, as has been pointed out previously, is that in early stages of industrial development labor is cheap, and the sorts of industries that emerge are labor intensive. One typical member of this category is the textile and apparel industry. Indeed, much of the newly created industry in Israel came in the form of textile factories as well as diamond-polishing plants. Almost a third of all growth in the number of people employed in industry from 1958 to 1965-66 is accounted for by these two industries.<sup>10</sup>

The heavy involvement of the government in industrial investment was manifested, in part, in the construction of industrial buildings by members of the public sector, such as municipalities. By 1965 an excess of such structures emerged. This could happen because construction took place without firm plans as to how the structures would be used. Buildings were being erected in the hope that their existence would attract industry.

Figures 1.1 and 1.2 indicate very clearly the recessionary nature of 1966 and 1967. In both years there were sharp declines in all categories of investment, both private and public. The important role played by big government projects was obvious to at least some observers at the time. One of them pointed out clearly that an important factor in the slump was the winding up of major government projects in 1965, without new ones to take their place. However, he failed to realize that the development was more than temporary. In fact, he expressed surprise that even at the start of 1968 there were still no plans for new government projects.<sup>11</sup>

We shall return to the question of the 1966-67 economic period, but first let us look at the period from 1968 until the 1973 war. In Figure 1.2, one observes a clear rising trend in the rates of change of investment from 1968 to

1972 and a clearly declining trend thereafter. What stands out is that the share of pure public investment items continued to decline until 1971. This implies that investment in those categories not purely public in nature increased faster than investment in public items. It thus looks as though the private sector, or at least the less public sector, picked up the slack left by the termination of a host of government investment projects.

In reality, something very different was happening. In June 1967 the Six Day War erupted. Within less than a week the Israel Defense Forces captured all of the Sinai peninsula, Judea, Samaria, Gaza, and the Golan Heights. These newly acquired territories exceeded in size the land area of Israel proper. This meant a concentrated effort of both military and civilian construction, implying both stepped-up public investment and increased consumption for defense. The latter included military camps, fortifications (among them the Bar-Lev Line along the Suez Canal), and roads. Thus, even though the war itself, and the preceding gestation period, caused a 57-percent increase in domestic procurement for defense (i.e., excluding imports of defense materiel), a further increase of almost 50 percent took place in 1969, with 1970 and 1971 each registering a 20-percent increase.

The construction-equipment sector can again exemplify the magnitude of the change. Although in 1967 investment in construction equipment all but vanished, in 1968 it almost returned to its 1965 level (a rise of 725 percent compared to 1967) and continued to increase at an average of 13 percent until 1972. But as far as investment is concerned, developments surrounding the war have been even more important than the war itself. First, France, which had been Israel's chief arms supplier, put an embargo on further shipments. This placed Israel in the intolerable position of being cut off from the supply source of the two most important weapons systems: combat aircraft and tanks. The government responded with an ambitious program designed to acquire the capability of producing both of these systems. Thus came into being the Merkava (literally Chariot) main battle tank and the Kfir (literally Lion Cub) fighter plane, for which the French Mirage served as a basis. The need to carry out these projects in as short a time as possible required considerable industrial investment by the public sector, including government corporations, who own the most important defense industries. Such investments always spawn secondary investments, and so private sector investment also rose sharply.

The main beneficiaries from the government's defense production program were the metal and electronics industries. Over the five-year period from 1968 to 1972, the real product of manufactured metal goods grew by 142 percent, or 19 percent per year. In 1972 the electric and electronics industry produced 232 percent more than in 1967, an average annual increase of 27 percent.<sup>12</sup>

However, the investment that made all this possible is not included in

the categories classified as pure public investment. Hence, the continued decline in the share of these categories after 1967. Nevertheless, the stepped-up investment was clearly the result of government initiative, which had to do with all sorts of considerations other than economic ones.

By 1972 the wave had begun to subside. The Bank of Israel observed that<sup>13</sup> "The reason for the stabilization of investment [in the metal industries] is mainly the slowdown in defense procurement from these industries. It was the demand of the defense system for the products of the metal industries which accelerated their development and the big investments in them." For this reason the share of pure public items increased again after 1971, and particularly so in 1974 and 1975, years in which investment in some of the other categories declined considerably. For example, purchase of ships and aircraft declined by 55 percent in 1974 and by another 73 percent in 1975.

In addition, investment in some pure public items increased, especially in agriculture, irrigation, and electricity. This was the result of a renewed settlement effort, directed at the newly acquired Golan Heights and areas south of Rafah, where the Gaza Strip joins the Sinai. Again, the settlement activity was hardly motivated by economic considerations. Politics and security had a lot more to do with it.

To complete the story, one must explain why even after 1973, investment in industry continued to grow quite considerably. As the data in the appendix reveal, investment in industry and mining grew by a healthy 14.2 percent in 1975. Even though this seems to contradict what has been argued, government behavior is again the cause. The rate at which the government subsidized new capital formation increased steadily over time. According to one estimate, the rate at which capital formation was subsidized increased from just 3.2 percent of all capital formation in 1964 to 35 percent in 1977. This means that, by 1977, many approved investments were actually subsidized at more than 50 percent, because the overall subsidization rate includes investments that received no subsidy at all. Most important, there was a real jump in subsidies during the period 1970–72, the last years of vigorous growth.<sup>14</sup> The average rate of subsidization leaped from 6.4 percent in 1969 to 11 percent in 1970 and 18 percent in 1971 and 1972.

Subsidization alone does not prove the point. What does is that it proved to be unproductive, as it created excess capacity in the industrial sector:<sup>15</sup> "[The increased investment] is surprising in view of the gap which exists between the required industrial capacity and the actual one, as reflected in the industrial stock of capital. Since 1972, industrial capital has increased much faster than necessary to facilitate output." It follows that part of the investment took place not because of the availability of good opportunities, but rather because it came cheap to the investors.

One possible corroboration of this view is lent by gross investment fig-

ures. Throughout the period 1971–75, gross domestic investment constituted around 30 percent of GDP. Its weight in the GDP started to decline seriously only in 1976 and 1977. Yet, the growth rate of the GDP was down from 12.1 percent in 1972 to 3.4 percent in 1975. How could this be explained without the observation that much of the investment, in both housing and industry, simply did not bear fruit?

Certainly the heavy investment in defense industries contributed greatly to Israel's capabilities in the design, engineering and manufacturing of metal and electronics products; and thus put Israel in a position to compete in the modern world, at least as far as human capital is concerned. However, this is largely a fortuitous outcome, and it comes at a heavy price because the fortunes of the defense industry depend on developments that are mostly political and not economic. Political events are hard to foresee, which makes it difficult to adjust in a gradual manner. Events in Eastern Europe during 1989, for instance, came largely as a surprise. The upshot is a considerable decline in demand for armaments, putting a squeeze on defense-based manufacturers. It is a very shaky proposition to base a substantial part of a country's industry on defense.

Turning to residential construction, Figure 1.1 indicates that in 1968 only the private sector increased its activity, whereas public investment was still declining and its share hit bottom that year. Then in 1969 there was a huge increase in investment, by both the private and the public sectors. At that point the housing market had been showing clear signs of excess demand, as the unsold stock of apartments disappeared. There was also an increase in immigration. After almost no net immigration in 1966–67, numbers began to pick up again, increasing steadily until 1973.

In 1970 the rate of increase in residential construction declined, as houses started in 1969 were being completed and the pressure of excess demand was beginning to subside. Still, the level of investment was on the increase. It seems that by 1972, as a result of the intensive activity since 1968, a stock of unsold apartments began accumulating once again.<sup>16</sup> In fact, a good deal of the construction activity in 1972 was due to housing starts that had taken place in the latter half of 1971.<sup>17</sup> The private sector was therefore simply reacting to economic developments, as it should have done. The government, on the other hand, kept on increasing its housing investment as though nothing had changed. As Figure 1.1 indicates, not only did the government increase its activity in 1973, but it kept doing so in 1974 and 1975 as well. This behavior prompted the Bank of Israel to remark that<sup>18</sup> "in 1974 public building starts took place on a wide scale although it was known that an unintended stock of apartments was accumulating, following the continued slowdown in sales of apartments to the public and the steep decline in net immigration."



Why did the government increase its residential construction activity despite the evident accumulation of unsold housing? The Bank of Israel speculated that the government was reacting to pressure from construction companies, who clamored for replacement of falling private business. More likely, the pressure was generated not because of declining private investment, but because of reduced construction for defense. A situation of this kind is typical, as we shall see later on, of economies with excessive governmental involvement. Another possible explanation is that the government, faced with lackadaisical private economic activity, was trying to keep the economy going by other means. This could be accomplished by a combination of increased public consumption and public investment. The latter course was preferred, because the tendency to increase government consumption expenditures had been under criticism since 1970. But the government was in no better position to identify new investment projects than it had been in on the eve of the 1966–67 slump. Having run out of defense-related investment opportunities as well, the government opted for the quick fix and continued to pour concrete.

One other aspect of Table 1.2, comparing Israel with some other economies, requires explanation. As is evident, the rate of capital accumulation during the third five-year period remained exceptionally strong in Israel, although declining considerably in the communist economies that serve for comparison, especially in East Germany. This may be explained by the fact that Israel continued to have access to sources of capital of a kind denied all the communist countries shown in Table 1.2. Whereas these countries depended almost exclusively on domestic savings for the finance of further investment, Israel enjoyed sustained, large capital imports. That is, Israel could rely on external financing of investment.

A good idea of the extent to which capital imports facilitated domestic investment can be obtained from Table 1.3.<sup>19</sup> The deficit in the goods-and-services account (henceforth referred to occasionally as *excess imports*) exceeded two-thirds of domestic investment throughout. It is also evident that during the half-decade containing the slump of 1966–67, the share of excess imports in domestic investment was particularly high.

On the basis of what has been said, it must be concluded that the engine that powered Israel's growth ran out of steam in 1966, because the government ran out of obvious investment opportunities. Only the aberration of the Six Day War and its aftermath gave the economy a temporary reprieve, as the government once more found obvious investment opportunities. And once the government ran out of those, too, the economy slid inexorably into its present lackluster economic performance.

This summary of developments contrasts sharply with the accepted view. According to conventional wisdom, what happened in 1966–67 was a regular recession, partly engineered by the government, from which the econ-



TABLE 1.3

The Deficit in the Goods and Services Account as Percent of Domestic Investment

Period	1951-55	1956-60	1961-65	1966-70	1971-72
Percent	82.9	72.0	69.3	87.6	74.3

omy recovered after 1968.<sup>20</sup> In this view, the government was forced into a recessionary policy by what it perceived as a worsening balance-of-payments situation and inflationary pressures.

If the conventional view of the 1966-67 episode as a recession is to be defended, then its proponents must change their story. For assuming that the government really did intend to create a recession, were its fears founded? The question is examined in Table 1.4, which reveals that none of the indicators often used showed significant, or indeed even any, deterioration in 1965. Excess imports as a percentage of GDP continued to decline in 1965, after a slight increase in 1964. The same holds for the ratio of imports to exports. In fact, in 1965 exports paid for a higher percentage of imports than in any other year represented in the table. True, unilateral transfers paid in 1964 for only 58 percent of excess imports, after having paid for over three-quarters of excess imports a year earlier. But the share of transfers in the finance of excess imports increased again in 1965. Finally, the current-account deficit, having more than doubled from 1963 to 1964, declined again in 1965.

As for inflation, the consumer price index increased by more than 4 percent during 1964 and by about 7 percent in 1965. This rise in the rate of infla-

TABLE 1.4

Balance of Payments Deficit Indicators

Year	Percent			Current Account millions of dollars
	Excess Imports of GDP	Imports of Exports	Unilateral Transfers of Excess Imports	
1962	22.4	205.7	70.6	-135.9
1963	20.1	191.4	76.9	-102.0
1964	21.8	199.2	57.9	-237.6
1965	19.1	187.5	62.6	-191.8

Source: CBS, *Statistical Abstract of Israel, 1969 and 1982*. The first two indicators are in terms of national accounts, whereas the last two are in terms of balance of payments.

tion could constitute a legitimate cause for concern. But monetary developments during 1966 put in doubt the degree to which the government had been concerned with inflation, as the money supply grew by about 109 percent.<sup>21</sup> The question of why the decline of growth rates was, relatively speaking, so abrupt, is left to the last section of this chapter.

### Growth Does Not Mean Efficiency

The observation that Israel's economy grew for a while at respectable rates is not the same as saying that the economy performed efficiently. To establish efficiency, one would have to demonstrate that the realized growth rates justified the capital investments that produced them. For the condition to hold, those investments in fact undertaken must have proved capable of producing a rate of return at least as high as could be secured in alternative uses of the capital. In a market economy, it is the market mechanism that imposes a selection process favoring the best investment opportunities. Furthermore, if an enterprise, albeit profitable, could be made even more so, there is always the possibility of takeover by entrepreneurs who believe that they are capable of realizing the full potential of an existing capital stock. In a market economy, therefore, there is no reason to believe that the existing capital stock is invested in a pattern that deviates sharply from the most efficient pattern.

In Israel, the market test hardly applies. Free access to capital has been virtually nonexistent, a topic with which Chapter 2 deals in detail. There has been very extensive protection, in the form of both subsidies and import duties, and there has been a lot of cartelization and monopolization. It is therefore quite possible that at least part of the capital invested has been allocated suboptimally.

Data are only partly capable of substantiating this assertion. The degree of distortion in the economy may be such that a reallocation of capital expenditures could prove to affect the economy more than marginally, in which case we would have to consider comparing two different economies. If this were the case, then even if we had found, for instance, rates of return on the existing capital stock to be quite high, this still would not have proven efficiency, for these rates already reflect, for example, the artificially high prices brought about by import restrictions. More generally, rates of profit do not reflect general economic welfare. Rather, they may reflect a very skewed income distribution. As an example, consider the carpet industry, dominated in Israel by Carmel Carpets. The duty levied on imported carpets has been exorbitant—upward of 150 percent on many kinds of carpets. Consequently, Israelis have been paying outrageous prices for domestically produced carpets. It thus stands to reason that domestic carpet production has generated a handsome return on the capital invested in it, but this certainly does not imply an efficient allocation of capital. In the absence of a methodology that would allow us to

examine the degree of efficiency of capital investment, the only alternative is to examine critically whatever data exist and evaluate individual incidents.

Armed with the various caveats, let us consider the existing evidence, beginning with the data in Table 1.5. This table constitutes an attempt to indicate the sort of impact that government intervention may have had on the allocation of investment capital. The table is organized by rate-of-return categories, the industries with the highest rates being the most profitable ones. Approved establishments are those that qualify for the privileges granted under the Law for the Encouragement of Capital Investment (henceforth LECI; see Chapter 2 for details). The premium per dollar's worth of exports represents the excess of the exchange rate granted exporters over and above the official rate of exchange.

As the table indicates, the government had a tendency to provide especially generous assistance for the less profitable enterprises. In fact, in the period 1965-72, the degree of public finance of investment bears an exact inverse relationship to the degree of profitability. Thus, although in the most profitable category the government provided only 17.9 percent of the finance, it provided fully 42.5 percent of the finance in the least profitable category. One item stands out: from 1965 to 1972 the government provided 79 percent of the finance for investment in mining and quarrying, almost double the next highest rate (and almost three times the industrial average). Yet the rate of return on capital in mining and quarrying has been the lowest of all. The proportion of approved plants in this sector was also one of the highest. The impression that the government has tended to support the less profitable enterprises is confirmed by the negative coefficient of correlation (-.5) found between the rate of return on capital and an index of government intervention.<sup>22</sup> In addition, no positive relation between the proportion of output destined for exports and the rate of return could be discerned.

TABLE 1.5

## Investment Returns and Government Involvement

Rate of Return Category, % 1965-80	% Approved Plants, 1975	Premium per Dollar of Exports, % 1973-80	Index of Government Finance, % of Investment	
			1965-72	1973-80
22.5-27.8	48.6	30	17.9	34.0
17.9-21.5	33.6	31	20.4	55.0
15.8-17.6	38.2	34	30.8	47.0
10.7-14.8	40.9	27	42.5	34.0

Source: Bregman, *Industry and Industrial Policy in Israel*, p. 13.

Concerning the actual average rates of return, the Bregman study which provided much of the basis for this discussion, quotes two estimates. The first, based on a representative sample of Israel's industry, reports the average annual industrial rate of return on capital over the period 1960-68 to have been 13.3 percent.<sup>23</sup> The second estimate, which is based on national account data for the entire industrial sector, combined with capital stock estimates, reported that the rate of return on capital for the period 1965-72 was 17.1 percent per year, considerably higher than the first figure.<sup>24</sup>

The caution with which these numbers must be treated is exemplified by another study, which also took the sample approach. There, the cost of equity capital for the period 1964-77 is estimated to have been an average annual 9.7 percent.<sup>25</sup> One piece of somewhat unsettling evidence emerges from a comparison of rates of return on equity shares and on bonds. Between 1952 and 1969, the average annual real rate of return on all shares traded was 6.9 percent, whereas the comparable rate on exchange-rate indexed bonds was 7.4 percent.<sup>26</sup> One could use still another indicator, the national account data for the business sector as a whole. Such data, concerning the evolution of capital stock, product, labor input, and wages, indicate that between 1960 and 1972, the rate of return to capital had been on the increase, and this is particularly true for the period 1966-72, when the business sector product grew an average 9.2 percent annually, although the capital stock grew only at an average annual rate of 7.5 percent.<sup>27</sup>

Another way of assessing the economy's performance during the years of high growth rates is to consider individual episodes of prominent failure, which indicate that the government was incapable of distinguishing good investment opportunities from bad ones. Some may object to this approach on the grounds that high rates of failure among businesses during the first years of existence are quite common. For instance, in the United States it is estimated that three out of every five new enterprises fail during the first five years. Although there can be no exception to this objection in general, the situation is somewhat different when the government is involved, for government involvement eliminates a good deal of the uncertainty and so allows the investor to start at the outset on a much larger scale than would have been dared otherwise.

The contribution of productive assets constructed in any particular year to the national product is evaluated not by the future return to these assets, but by the cost of constructing them. If a business collapses before the cost of the investment has been recovered, the implication is that growth had been overestimated at the time of investment. But in practice such corrections are not being made. Rather, the collapse of an enterprise is charged against growth during the year in which the debacle occurred. It follows that past, overestimated growth rates are offset by present, underestimated growth

rates. This implies that what appeared as spectacular growth rates in Israel during the 1950s and 1960s were not quite that spectacular after all. Some examples follow.

The first two fiascos considered concern adventures in the assembly and production of cars in Israel. Of the two auto plants, the first was opened in 1951, with the majority shares held by the Ilin family. The opening date is not a coincidence: the project had started right after the passage of the Law for the Encouragement of Capital Investment (see chapter 2), and Ilin was one of the first to enjoy its benefits. The plant assembled Kaiser-Fraser cars, and when the American company went out of business Ilin switched to assembling Studebaker cars. When that company, too, ceased operations, Ilin began to assemble another car, Contessa, whose original producer also went bankrupt later on. Through it all Ilin expanded, obtaining considerable government finance in the process. It even managed to export cars. This was made possible by the exorbitant duties imposed on imported cars, which enabled Ilin to continue its very inefficient operation, but also granted it a clear advantage in the domestic market, as prices of imported cars exceeded even the prices of its own costly product. The extent to which the company enjoyed a preferred status in the Israeli market could be easily discerned from the highway scenery. When Ilin assembled Henry J cars, the roads were full of those; later Studebaker became the dominant model on Israel's highways and so on.

One of the more comic events in Ilin's story is the exclusive concession it received from the government to import Colombian coffee, a move designed to ease its financial difficulties.<sup>28</sup> The government went on providing Ilin with all sorts of assistance until it became clear that the company could never be made profitable, so it was sold in 1969 to Autocars, the second car producer destined for failure, with money provided by the government.

Autocars differed from Ilin only in that the latter assembled cars solely from imported parts, whereas the former also produced some of the parts. The company entered a partnership with British Leyland, itself a troubled behemoth, to supply buses and trucks to the Israeli market, with a government guarantee of monopoly. Consequently, for several years Israel's entire bus fleet was made up of Leyland Tiger buses. Moreover, the financial arrangements accompanying the deal were decidedly inferior to what could have been obtained from alternative sources of supply.<sup>29</sup> The Autocars scandal reached such proportions that in March 1971 it was taken up by the Knesset, which hastened the demise of the company at the end of that year.

Whereas in the two auto stories there is no way to tell how much public money went under when the companies did, the next story, which concerns shipping, provides a better idea as to the magnitude of the disaster. In 1959, Meir Halevi convinced the Israeli government to join with his Swiss company, Somerfin, in building a versatile seagoing fleet, comprising passenger